

# Daikoku Denki Co., Ltd.

6430

Tokyo Stock Exchange First Section and Nagoya Stock Exchange First Section

24-Jan.-2020

FISCO Ltd. Analyst

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FISCO Ltd.

<http://www.fisco.co.jp>

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## Summary

**In 1H FY3/20, both sales and profits rose above plan, but given the uncertainty surrounding the industry, the Company has left its full-year results forecast unchanged. Launch of the industry's first AI hall computer "X (Kai)" is proceeding smoothly.**

### 1. Business overview

Daikoku Denki Co., Ltd. <6430> (hereafter, "the Company") has two main businesses: one that develops, manufactures and sells computer systems for pachinko (Japanese slot machines) parlors and halls, and the other that develops, produces and sells display and control units for pachinko and pachislot machines. The Company holds the leading market share, approximately 35%, of the Japanese market for hall computers, reflecting an information management method that is the de facto standard for the industry. Furthermore, the industry's leading membership-based information provision service Daikoku Denki Strategic Information System (DK-SIS) to support the operations of pachinko hall associations forms a network of 3,542 pachinko halls and supports the Company's business foundation.

Japan's pachinko market has been shrinking over the years. In response, the Company has been working to reform its businesses over the medium to long term. Reforms include developing a next-generation hall computer, shifting to a business model more reliant on services that provide recurring revenue, and developing in-house developed pachislot game machines. However, with the series of revisions to regulations (including controlled ball payouts and measures against gambling addiction) having brought the industry to a major turning point, current earnings remain difficult due to the impact of uncertainty about the future. In June 2019, the Company released the AI hall computer "X (Kai)," the first of its kind in the industry, as the Company started in earnest on its efforts targeting future business expansion. Toward a new era with machines under new regulations, the Company is aiming to increase its market share and boost profitability while helping hall operators improve efficiency and save labor

### 2. 1H FY3/20 results

In 1H FY3/20, the Company's sales and profits both increased significantly, with net sales up 31.0% year on year to ¥18,643mn and operating income rising 49.3% YoY to ¥1,302mn, both above plan. Net sales in the Information System Segment grew at a pace that exceeded plan. Even in the midst of a challenging market environment, the Company's CR unit "VEGASIA III," widely lauded for the strength of its security features, performed well, and the launch of the newly introduced AI hall computer "X (Kai)" has also proceeded smoothly. Meanwhile, the Control System Segment also gained an increase in sales that exceeded plan because of strong sales of control units and components, and despite struggling sales of display units for pachinko and pachislot machines. Growth in the Information System Segment contributed significantly to an increase in profits, with the Company's operating margin improving to 7.0% (compared to 6.1% in 1H FY3/19).

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## Summary

**3. FY3/20 forecast**

The Company has left its initial forecast for FY3/20 unchanged, with an increase in sales but a decrease in profits, looking for net sales of ¥34,000mn (+9.1% YoY) and operating income of ¥1,200mn (-21.5%). Net sales are expected to benefit from continued strength in the Information System Segment. In particular, the Company's policy is to move forward with upgrades to the system used as a base for hall operational management, replacing it with the AI hall computer "X (Kai)," thereby spurring its ability to deploy new, high-value-added products and services while attracting and keeping customers. Meanwhile, the forecasted decline in profits is due to replacement of core systems, sales promotion costs, as well as depreciation in conjunction with the release of the AI hall computer "X (Kai)." Note that despite 1H results exceeding plan, the Company has left its full-year forecast unchanged. This is due to the fact that certification of mainstay pachislot machines under previous regulations will expire at the end of December 2019, and uncertainty about the impact their replacement with machines under new regulations will have on results (particularly on sales of display units for pachinko machines).

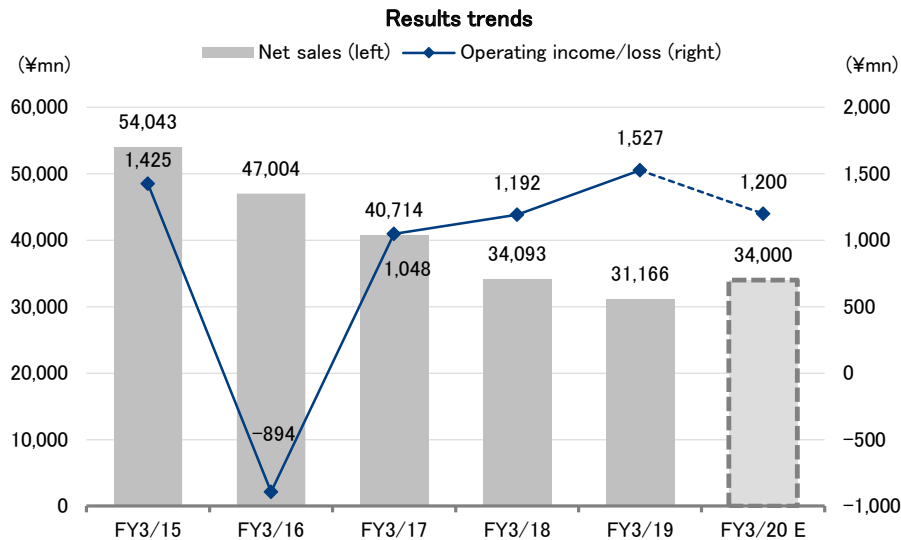
**4. Future strategic direction**

In the Company's view, regulatory revisions and other changes in conditions surrounding the pachinko industry will, in the medium to long term, represent a good opportunity for the industry to evolve into one that enjoys even wider public support. The Company's policies are focused particularly on expanding market share with its industry-first AI hall computer "X (Kai)" and other next-generation products, as well as on creating new value through its data analytics and planning and development capabilities, which will contribute to industry growth while also leading to improved growth and profitability for the Company itself. In the medium to long-term view, at FISCO we are also keeping a close watch on the Company's efforts to revitalize the industry as a whole, and its M&A action both in and outside the industry.

**Key Points**

- In 1H FY3/20, the Company increased both sales and profits in excess of plan
- Launch of the industry-first AI hall computer "X (Kai)" is proceeding smoothly
- The Company has left its full-year forecast unchanged in light of uncertainties in the industry associated with replacement of machine under new regulations
- Toward a new era under machines with new regulations, the Company aims to increase its market share and improve profitability by helping pachinko halls improve their operating efficiency and save labor, as well as by providing new value leveraging data.

## Summary



Source: Prepared by FISCO from the Company's financial results

## Description of businesses

### Holds the No. 1 market share in hall computers and peripheral equipment for the pachinko industry with support from provision of the industry's main information control method

While emphasizing on development, production and sales of computer systems for pachinko halls, the Company also develops, manufactures and sells display and control units for pachinko and pachislot machines.

As a pioneer in the development of hall computers, which assist in the management of pachinko halls, and holder of the top market share in the Japanese market, the Company won halls' trust and satisfied pachinko players by proposing a management method which puts emphasis on data management, introducing innovative peripheral equipment for its hall computers and providing the industry's leading membership-based information provision service.

The Company's hall computer is utilized at roughly 3,517 halls (giving it a share of about 35.0%) and around 1,873,000 amusement machines are installed (about 43.5% share).

The Company's two main businesses are the Information System Segment and the Control System Segment, but the Information System Segment provided 80.0% of its net sales in 1H FY3/20 and has been the main source of stable profit in the past few years.

Description of businesses

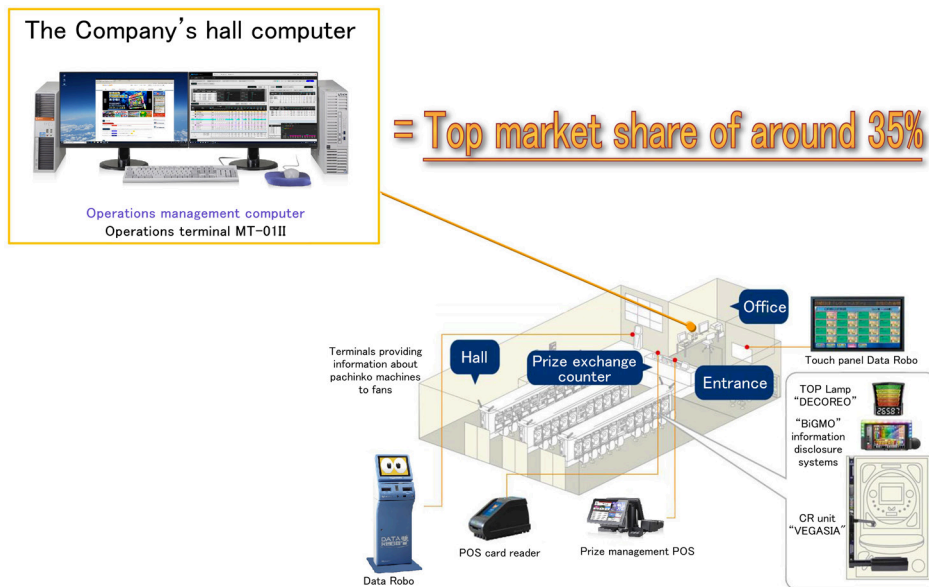
1. Information System Segment

The Information System Segment offers a complete line of information equipment and services necessary to support operational management at pachinko halls. It sells hall computers, which are the core of the system used at pachinko halls, and peripheral equipment, such as prize management systems and information disclosure systems. The segment also offers hall management support services through information equipment and the membership-based information provision service DK-SIS, which is the leading service in Japan that provides strategic information about associated halls.

Hall computers are the core systems for supporting pachinko hall operations. These computers display the operating conditions and sales of each machine in a hall. These computers are supported by peripheral equipment, such as prize management system and information disclosure system. They also serve as the foundation of the membership-based information provision service. Introducing a hall computer provides the advantage that peripheral equipment and support services can be sold as a package deal. The Company has been aiming to transition to a business model that provides recurring revenue by collecting membership fees such as its aftersales management support services and information provision service in addition to information equipment sales.

In June 2019, the Company released the industry's first AI hall computer "X (Kai)" for the first time in 12 years after the release of a hall computer "CII." Based on the concept of a "hall computer that teaches," the main feature of this AI hall computer is that it will guide pachinko hall operators to the optimal solutions by utilizing the Company's big data and having AI automatically analyze the data. By helping pachinko hall operators improve their operating efficiency and save labor, the Company aims to expand its market share and increase its profitability.

Hall computers and main peripheral equipment



Source: Prepared by FISCO from the Company's results briefing materials

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## Description of businesses

## 2. Control System Segment

The Control System Segment produces and sells displays and control units, as well as components used for pachinko and pachislot machines for amusement machines manufacturers. Applying the knowledge obtained from analyzing data from pachinko machines as a hall computer manufacturer for many years, the segment serves as a development partner for the content as well, moving beyond the scope of a machine manufacturer by proposing specs based on the trends of popular models and acquiring copyrights for popular characters.

Since FY3/14, the Company's consolidated subsidiary Daxel Co., Ltd. has been producing and selling pachislot machines developed by Daikoku Denki under the Daxel brand name. However, from FY3/19, the development plans were revised based on the market environment and other factors, and the Company is taking a cautious stance.

## ■ Company strengths

### Track record of creating new opportunities for the industry and provides added value for hall management in various aspects

#### 1. Growth model based on market expansion through innovation

Since its establishment, the Company has consistently planned and developed new categories of goods and services, thereby developing the pachinko market and achieving growth. It has not just developed machines with superior functions but emphasized the importance of data management and the necessity for information disclosure. Thus, it has been able to provide added value from various aspects to management of pachinko halls.

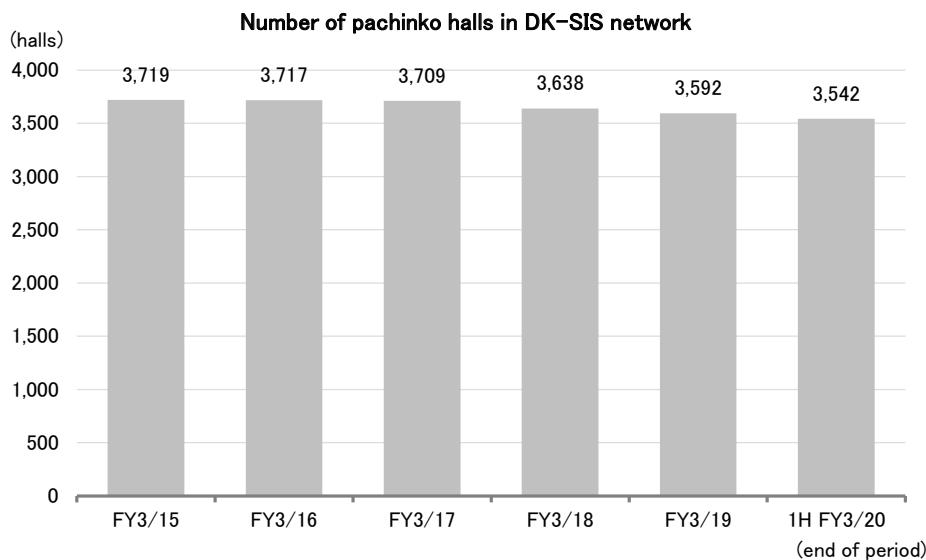
Launched in 1974, the Company's first hall computer enabled the managers of pachinko halls to introduce a hall management method based on data management. Previously, pachinko halls accumulated only basic data, but with the introduction of hall computers, data-based hall management became the de facto standard. In subsequent years, the Company has been introducing information equipment with revolutionary functions which is the first of its kind in the pachinko industry consecutively. One such piece of equipment was the Data Robo terminal, which provides information about different models of pachinko and pachislot machines to the players of these machines. This equipment has increased the satisfaction of pachinko players and the efficiency of pachinko hall management, and hereby improved the profitability of pachinko halls.

In June 2019, the Company released the industry's first AI hall computer "X (Kai)." This AI hall computer will greatly help pachinko hall operations, for which shortage of manpower is an issue, by improving operating efficiency and reducing necessary labor by having AI automatically analyze big data that the Company possesses.

Company strengths

**2. Strong network of pachinko halls**

Another advantage the Company has is its membership-based information provision service, DK-SIS. This service creates an information network connecting the Company and member pachinko halls, and processes and analyzes the daily operational information of pachinko halls recorded by hall computers and gives feedback to hall managers to help their operations. It enables the managers to conduct effective hall operation utilizing valuable external information, including nationwide pachinko machine information and operational data broken down by machine model. At the same time, this strong network made up of members also supports the Company's business foundation. Additionally, it occupies an industry think-tank role and contribute to improve the Company's brand as a leading company, and utilized to its strategic proposal and sales activities to amusement machines manufacturers. Membership totaled 3,542 halls at the end of September 2019 with 1.47mn managed machines (34.3% share in managed machines) and ¥9.1tn in data scale (annual sales). While member volume has peaked amid a recent decline in overall pachinko halls, DK-SIS enjoys a large share in managed machines, mainly at large sites.



Source: Prepared by FISCO from the Company's results briefing materials

**3. Stable profit base that supports investment for the future**

The Company's main source of competitiveness is its proactive upfront investment eyeing future growth, including its R&D expense. Over the past few years, the Company has developed unique pachislot machines, a next-generation hall computer (and peripheral equipment), and other products to drive its sales and profit growth hereafter. The stable revenue stream provided by the high-margin Information System Segment makes this investment possible. In particular, the management support services (hereafter, "MG services") which have been promoted by the Company as a recurring revenue business model have grown and enabled funding of R&D at a high level while maintaining stable segment operating income, and investment risk has been limited. The Company's ability to balance large profits from its existing businesses with heavy investment in businesses for the future growth allows it to produce value on a continuing basis. From FY3/18 onwards, R&D expenses have continuously been on the decline because of a lull in major investment in the next-generation hall computer, etc. Going forward, the Company intends to proactively invest its R&D expenses in fields including data analysis features related to AI hall computer "X (Kai)," which has already been introduced in the market.

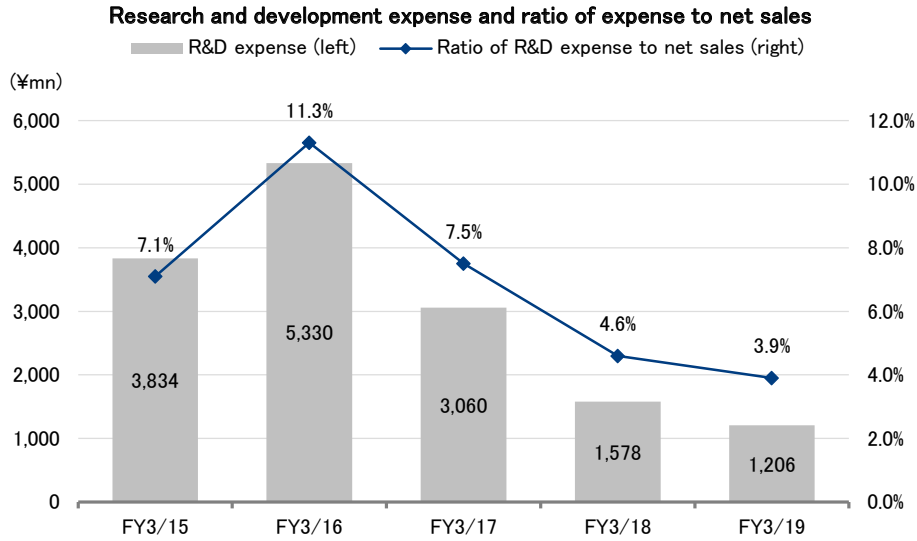


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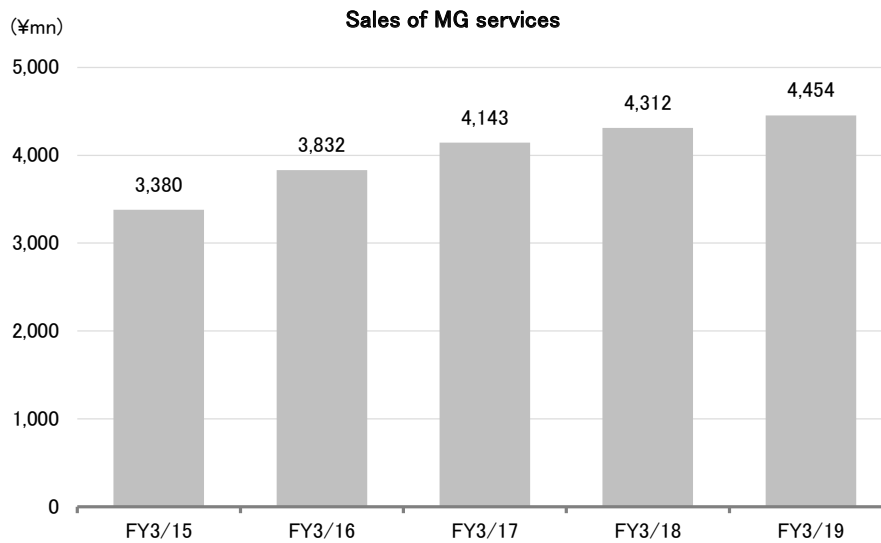
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Company strengths



Source: Prepared by FISCO from the Company's financial results



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## Industry environment

### While the deadline for removing mainstay pachislot machines by the end of 2019 leaves some uncertainty for the time being, in the medium term it is a good opportunity for business expansion

Japan's pachinko industry has been shrinking for years, reflecting a decline in the overall number of pachinko players, a trend toward playing games with low rental costs for balls, increases in Japan's consumption tax, and other factors. The self-regulatory action taken by the industry in 2015 (tightening restrictions on both pachinko and pachislot machines with strong gambling elements) left the whole industry in a slump in 2016 as it started to grapple with the problem of collecting and removing all pachinko machines that may perform differently from certified standards. Since the Regulations Regarding the Certification of Game Machines and Examination of Model (enforced on February 1, 2018, hereafter, "new regulations")<sup>\*1</sup> were officially announced on September 4, 2017, the industry has remained in a state of flux due to a pessimistic view and uncertainty toward the industry. While amusement machines manufacturers is announcing pachinko machines with a settings feature which is capable of setting the probability of major wins at up to six levels and type-6 pachislot machines as amusement machines that comply with new regulations, the industry has not begun full-fledged deployment yet due to the limited number of certified models at this stage and undecided market assessment of certified models<sup>\*2</sup>. As for pachislot machines in particular, the certification of mainstay models with strong gambling elements which had been the breadwinners for the management of pachinko halls had expired at the end of December 2019 (deadlines for removing), and therefore uncertainty arises in terms of its impact on the management of pachinko halls and the outlook of capital investment in association with the transition to machines under new regulations. However, we expect increased investments by halls targeting survival (customer draw) amid market releases of machines under new regulations as the industry advances in removal of machines under previous regulations. Manpower shortages have worsened for hall operations too. This is likely to spur deployment of facilities and equipment that provide labor savings.

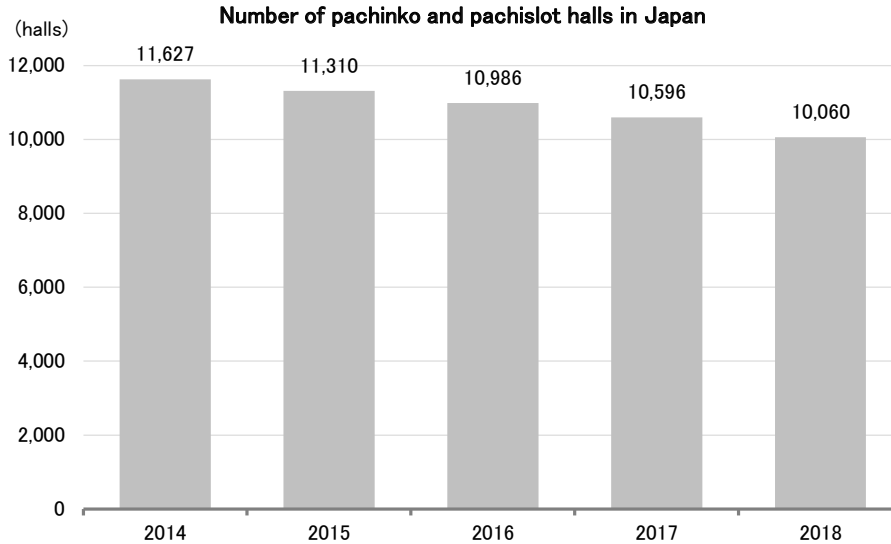
<sup>\*1</sup> Among the new regulations are restrictions on the maximum number of balls that can be paid out and clearly defined standards for "controlled machines." However, although more than one year has passed since the enforcement of the new regulations, there are still a large number of machines under previous regulations. Pachinko hall operators are worried that their earnings will decline and they will be faced with difficult decisions about the timing of equipment replacement and other matters. This has likely prolonged their diminished investment appetite (cautious stance).

<sup>\*2</sup> According to Company estimates, the rate of deployment of machines under new regulations as of the end of October, 2019 was about 32% for pachinko and about 22% for pachislot. Because of successive impending deadlines for removing machines under previous regulations, however, the transition to machines under new regulations is seen as gradually progressing prior to January 2021.

According to surveys by the National Police Agency, the number of pachinko halls in Japan declined at an average annual rate of 2.7% from 2011 to 2018. In particular, there is a noticeable decline in new hall openings due to the impact of the new regulations and other factors. In 2018, the number of halls was 10,060 (down 536 YoY). It is estimated that the Company served about 3,517 of these halls based on the fact that it held approximately 35% of the Japanese market for hall computers. The Company's customer halls are often high-end, large pachinko halls that are the top performers in their respective local market which exceed the market average in size\*. Average amusement machines volume per store is 533 machines, surpassing the average at other companies (371 machines) by about 40%. The customer base hence is fairly resilient to economic fluctuations and possesses healthy investment resources. As the Company moves toward a new era with machines under new regulations, we expect an excellent opportunity for the Company to expand business once investment appetites recover mainly at large halls.

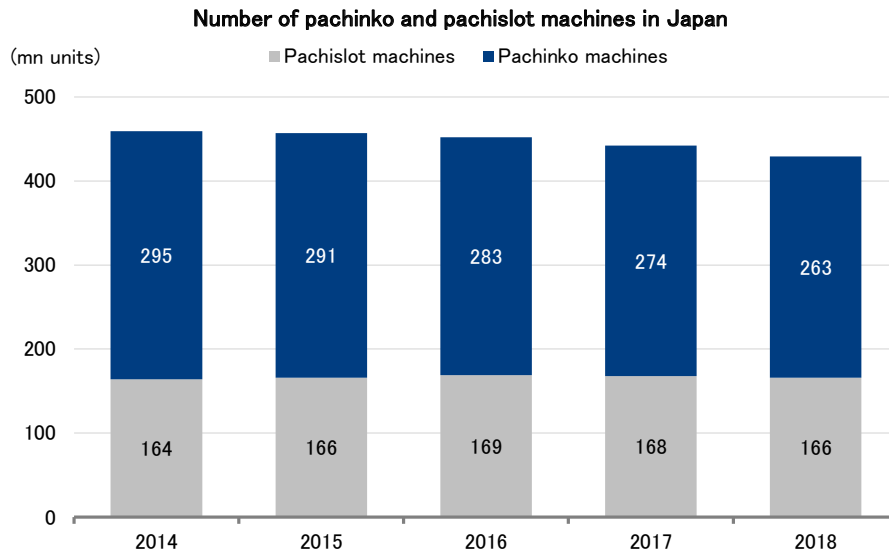
\* The Company holds a roughly 54.2% share in mid-sized to larger sites (501 to 1,000 machines) and around 75.0% in large sites (1,001 or more machines). Its market presence is higher at large sites.

Industry environment



Source: Prepared by FISCO from the Present State of Public Moral Environment and Crimes Related to Public Morals for each year and other information from the Community Safety Bureau, Safety Division, National Police Agency

Meanwhile, although the number of amusement machines is on a downward trend (the decline in pachinko machines is particularly striking), the number of machines per hall is increasing, indicating that halls are becoming larger. As discussed above, larger pachinko halls that command economies of scale are the Company's main segment and this trend should benefit the Company with its ability to realize robust investment return through advanced functionality and added value.



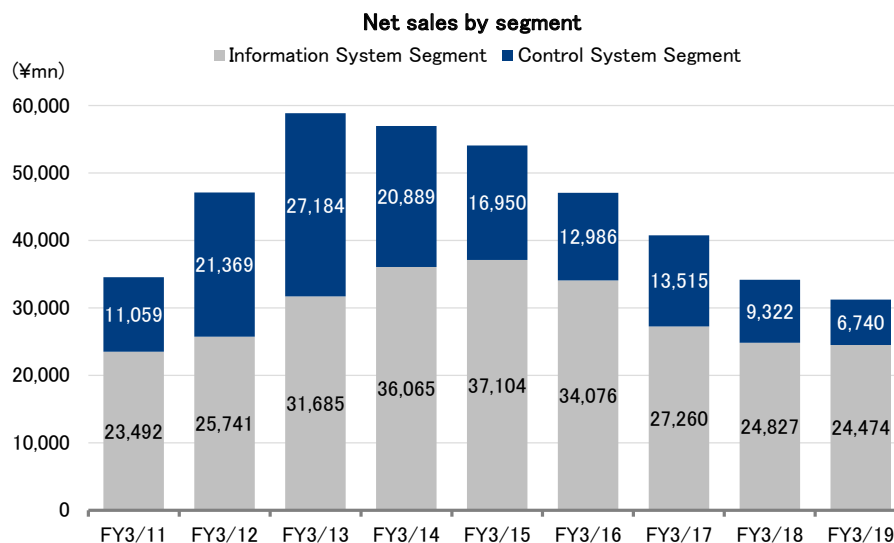
Source: Prepared by FISCO from the Present State of Public Moral Environment and Crimes Related to Public Morals for each year and other information from the Community Safety Bureau, Safety Division, National Police Agency

## Financial results trends

**Actively investing in R&D aimed at future growth, even amidst weak performance as the industry moves into a transitional phase. Signs of recovery seen in the short term.**

### 1. Performance over the past fiscal years

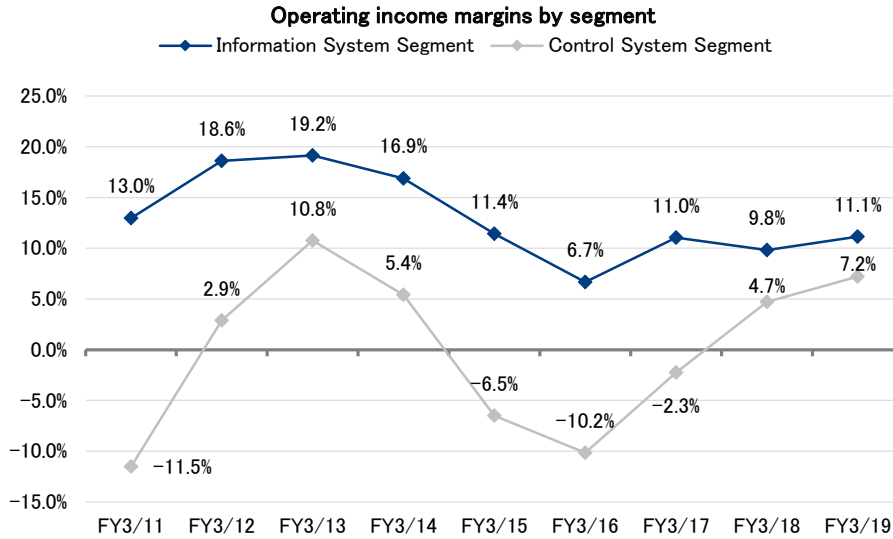
Looking back on the performance in the past nine fiscal years, the Company's sales shrank YoY because of restrained consumer spending and the impact of the Great East Japan Earthquake in FY3/11. Its results rebounded in afterwards, even though the pachinko industry continued to contract. This recovery was mainly led by the Information System Segment, which holds high market shares for its products. Net sales in this segment reached consecutive record highs in FY3/13–FY3/15, supporting the Company's overall performance. However, net sales have been contracting since FY3/16 (a decline for the sixth consecutive fiscal terms) due to various negative external factors, such as voluntary industry regulations, retrievals and removals of risky machines, and uncertainty related to new regulations.



Source: Prepared by FISCO from the Company's results briefing materials

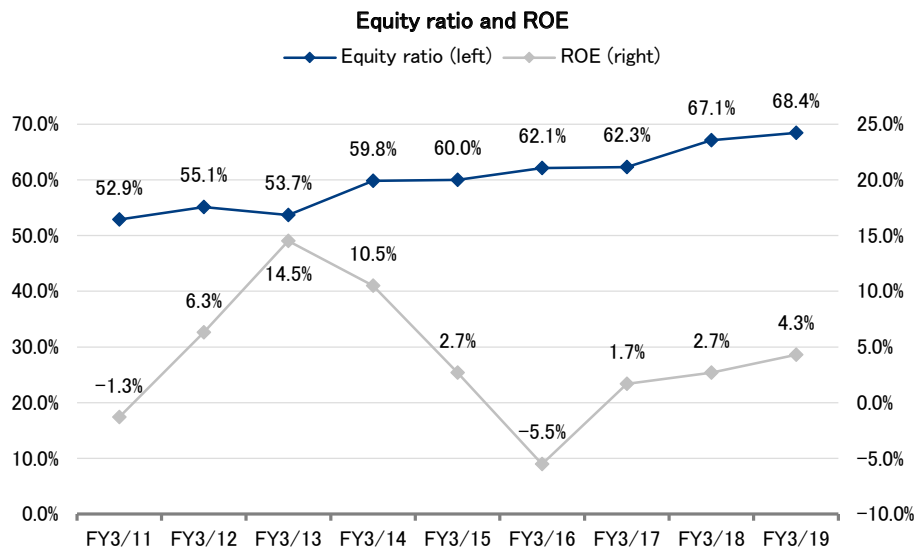
The Information System Segment becomes the source of profits, and has maintained high profit margins as the Company's performance recovered. Reflecting increasing investment in R&D for next-generation products since FY3/14, profit margins have declined, but considering the size of the investment, margins are still high. In particular, steady progress in conversion to a recurring-income business model, such as growth in MG service business, has been supporting income.

Financial results trends



Source: Prepared by FISCO from the Company's financial results

The Company's equity ratio, a measure of financial stability, has risen, reflecting large retained earnings, reaching 68.4% in FY3/19. The current ratio, which indicates the ability to make payments in the short term, was 213.9% in FY3/19, mainly due to large holdings of cash and deposits. The ROE, a measure of capital efficiency, has been low since FY3/15 due to a deterioration of net income. In FY3/15, the Company suffered a loss due to the bankruptcy of a manufacturer customer. In FY3/16, because of the industry restrictions on risky machines, the Company launched fewer new pachislot machines models than planned, and its sales volume of these machines was far below the planned level. As a result, the Company suffered a loss due to the devaluation of parts and materials for its pachislot machines. However, conditions have been gradually recovering recently.



Source: Prepared by FISCO from the Company's financial results

## 1H FY3/20 saw sales and profits increase significantly in excess of plan. Launch of AI hall computer “X (Kai)” proceeding smoothly.

### 2. Overview of 1H FY3/20 results

In 1H FY3/20, the Company saw a significant increase in sales and profits that exceeded plan, posting net sales of ¥18,643mn (+31.0% YoY), operating income of ¥1,302mn (+49.3%), ordinary income of ¥1,421mn (+41.4%) and net income attributable to owners of the parent of ¥912mn (+43.1%). The upturn in profits was particularly significant.

Net sales in the Information System Segment grew at a pace well above plan. The CR unit “VEGASIA III” and others performed well even under ongoing difficult market conditions, thanks to the continued strong reputation of its security features. Launch of the newly introduced AI hall computer “X (Kai)” has also gone well. Meanwhile, the Control System Segment also gained an increase in sales that exceeded plan because of strong sales of control units and components, and despite struggling sales of display units for pachinko machines.

Growth in the Information System Segment contributed significantly to increased profits. At the same time, the Control System Segment saw profits fall (recording a loss for the segment), due to sluggish sales of display units, an increase in R&D expenses and other factors, but profit growth in the Information System Segment was sufficient to make up for that drop. The Company’s operating margin also improved to 7.0% (compared to 6.1% in 1H FY3/19).

Cash and deposits increased, but total assets overall grew only slightly by 0.4% YoY, to ¥43,888mn. Meanwhile, equity increased 1.6% YoY to ¥30,366mn due to the accumulation of retained earnings. As a result, the equity ratio improved slightly to 69.2% (compared to 68.4% at the end of FY3/19).

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## Financial results trends

**Overview of 1H FY3/20**

	1H FY3/19		1H FY3/20		Change		FY3/20		vs. forecast	
	Results	Ratio to sales	Results	Ratio to sales	% change	Initial forecast	Ratio to sales	Achievement rate		
Net sales	14,230		18,643		4,412	31.0%	16,500	2,143	113.0%	
Information System Segment	11,077	77.7%	14,908	80.0%	3,830	34.6%	13,000	1,908	114.7%	
Control System Segment	3,173	22.3%	3,750	20.1%	576	18.2%	3,500	250	107.1%	
Adjustment	-20	-	-15	-	5	-	0	-15	-	
Gross profit	5,722	40.2%	6,682	35.8%	960	16.8%	6,000	682	111.4%	
SG&A expenses	4,850	34.1%	5,379	28.9%	529	10.9%	5,400	-20	99.6%	
Operating income	872	6.1%	1,302	7.0%	430	49.3%	600	702	217.0%	
Information System Segment	1,399	12.6%	2,309	15.5%	909	65.0%	1,500	809	153.9%	
Control System Segment	335	10.6%	-66	-	-401	-	100	-166	-	
Adjustment	-862	-	-940	-	-77	-	-1,000	60	-	
Ordinary income	1,005	7.1%	1,421	7.6%	416	41.4%	625	796	227.4%	
Net income attributable to owners of the parent	637	4.5%	912	4.9%	274	43.1%	400	512	228.0%	
Depreciation	842		1,022		180		1,040	-18	98.3%	
R&D expense	511		713		202	39.5%	560	153		
Information System Segment	430		406		-24	-5.6%	420	-14		
Control System Segment	80		307		227	283.8%	140	167		
<b>Breakdown of net sales</b>										
Information System Segment										
Equipment	5,836		9,310		3,474		7,612	1,698		
Service	5,241		5,598		357		5,388	210		
Control System Segment										
Units and components	2,558		3,040		482		2,770	270		
Pachislot machines and other equipment	615		710		95		730	-20		

	End of FY3/19	End of 1H FY3/20	YoY	
				% change
Total assets	43,729	43,888	159	0.4%
Total equity	29,898	30,366	468	1.6%
Equity ratio	68.4%	69.2%	0.8%	-

Source: Prepared by FISCO from the Company's financial results and results briefing materials

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## Financial results trends

The results by segment were as follows.

**(1) Information System Segment**

Both sales and profit increased significantly, with net sales up 34.6% YoY to ¥14,908mn, while segment operating income rose 65.0% to ¥2,309mn. Sales and profits are both progressing above plan. With the year-end deadline to remove mainstay pachislot models losing their certification, and despite difficult market conditions continuing with a depressed appetite for capital investment, the CR unit “VEGASIA III\*1” performed well thanks to the continued strong reputation of its security features. In addition, sales of information terminals for fans such as “BiGMO PREMIUM II” and “REVOLA,” with exclusive content compatible with the hit type-6 pachislot machines (based on new regulations), grew significantly, and the system upgrade to the AI hall computer “X (Kai)” introduced in June 2019 seems to be progressing smoothly. Thanks to growth in highly-profitable service sales\*2 and significant growth in profits from high-value-added sales proposals, operating income margins by segment also returned to a high level at 15.5% (compared to 12.6% in 1H FY3/19).

\*1 The most distinguishing feature of “VEGASIA III” is its built-in facial recognition camera that allows pachinko hall managers to get a good handle on player trends. In particular, customers have highly praised the realization of ideal model composition through data analysis and enhanced security features.

\*2 Service sales grew a strong 6.8% YoY, to ¥5,598mn (of which MG service comprised ¥2,309mn, up 4.7% YoY). The Company is focusing particularly on spreading use of “Market-SIS,” a trade area analysis service that displays information on how well customers in the surrounding area are being attracted.

**(2) Control System Segment**

While net sales rose 18.2% YoY to ¥3,750mn, the segment posted a loss of ¥66mn (versus a profit of ¥335mn in 1H FY3/19). Sales rose exceeded plan as well, but profits fell below plan. Sales of display units for pachinko machines declined YoY, but an overall increase in sales was made possible by strong sales of control units and components used in major titles. Profits fell significantly, however, due to depressed sales of display units and an increase in R&D expenses, resulting in a segment loss.

**Sales volume in 1H FY3/20**

	1H FY3/19	1H FY3/20	YoY change
Sales volume (Information System Segment)			
Hall computers*	36 units	31 units	-5 units
Call lamps			
BiGMO PREMIUM	13,977 units	19,533 units	5,556 units
REVOLA	10,183 units	20,244 units	10,061 units
IL-X series	11,017 units	6,585 units	-4,432 units
CR unit	19,681 units	34,023 units	14,342 units
Facial recognition system	11 halls	34 halls	23 halls
Sales volume (Control System Segment)			
Display unit models	6 models	4 models	-2 models
Units sold	45,953 units	25,660 units	-20,293 units
Pachislot machine models	0 models	0 models	0 models
Units sold	0 units	0 units	0 units

\*Number of hall computers does not include the number of system upgrades to “X (Kai).”

Source: Prepared by FISCO from the Company's results briefing materials

For the above reasons, looking back at 1H FY3/20 the Company can be highly regarded for having achieved results significantly exceeding plan, even as challenging market conditions continue. In the Information System Segment, it released the AI hall computer “X (Kai)”, the trump card in its growth strategy going forward—a launch that has gone well—and its new high-value-added products have been highly appraised by the market. The Company's ability to clearly demonstrate its strengths is thus powerful material for the future.



## ■ Outlook

### Initial forecast for FY3/20 maintained in the face of uncertain market conditions

#### 1. FY3/20 forecast

The Company has maintained its initial forecast for FY3/20, projecting an increase in sales but a decrease in profits, with net sales at ¥34,000mn (+9.1% YoY), operating income at ¥1,200mn (-21.5%), ordinary income at ¥1,250mn (-28.5%), and net income attributable to owners of the parent at ¥800mn (-36.7%).

In net sales, the Information System Segment is expected to continue doing well. In particular, the Company's policy is to move forward with upgrades to the system used as a base for hall operational management, replacing it with the AI hall computer "X (Kai)," thereby spurring its ability to deploy new, high-value-added products and services while attracting and keeping customers. In the Control System Segment, uncertain conditions associated with the transition to machines under new regulations are expected to continue, but the Company's policy of creating new attractive, pachinko machines optimized to the new regulations, and expanding its offering of plans and products utilizing new technology to machines as a whole, remains unchanged. Meanwhile, profits are forecast to decline due to replacement of core systems, sales promotion costs, as well as depreciation in conjunction with the release of the AI hall computer "X (Kai)."

Note that despite 1H results exceeding plan, the Company has left its full-year forecast unchanged. This is due to the fact that certification of mainstay pachislot machines under previous regulations will expire at the end of December 2019, and uncertainty about the impact their replacement with machines under new regulations will have on results (particularly on sales of display units for pachinko machines), as well the fact that posting of Control System Segment sales tends to concentrate in 4Q, resulting in possible timing differences.

The Company may be able to achieve its full-year projected results even if net sales fall to ¥15,356mn and operating losses to ¥102mn in 2H. At FISCO, we believe that while uncertainty about 4Q is a concern, given the Company's results in 1H and its near-term status, it is fully capable of achieving its full-year forecasted results, and attention needs to be paid to the possibility of an upswing (particularly in terms of profit). Close watch should be kept on industry moves following the removal of the mainstay pachislot machines that were breadwinners for halls to date; how those moves are read in terms of their impact on the Company is important. They could represent a watershed that will determine the future direction of the industry, and need to be followed carefully as an important objective circumstance when viewing the Company's growth scenario.

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## Outlook

**FY3/20 forecast**

	FY3/19		FY3/20		YoY change	
	Result	Ratio to sales	Forecast	Ratio to sales	% change	
Net sales	31,166		34,000		2,834	9.1%
Information System Segment	24,474	78.5%	26,000	76.5%	1,526	6.2%
Control System Segment	6,740	21.6%	8,000	23.5%	1,260	18.7%
Gross profit	11,673	37.5%	12,100	35.6%	427	3.7%
SG&A expenses	10,145	32.6%	10,900	32.1%	755	7.4%
Operating income	1,527	4.9%	1,200	3.5%	-327	-21.4%
Information System Segment	2,725	11.1%	2,500	9.6%	-225	-8.3%
Control System Segment	488	7.2%	700	8.8%	212	43.4%
Adjustment	-1,686	-	-2,000	-	-	-
Ordinary income	1,748	5.6%	1,250	3.7%	-498	-28.5%
Net income attributable to owners of the parent	1,263	4.1%	800	2.4%	-463	-36.7%
Depreciation	1,742		2,380		638	36.6%
R&D expense	1,206		1,210		4	0.3%
Information System Segment	1,124		1,050		-74	-6.6%
Control System Segment	82		160		78	95.1%

Source: Prepared by FISCO from the Company's financial results and result briefing materials

**2. FY3/21 outlook**

As noted above, industry trends in 4Q of FY3/20 need to be ascertained, but is highly likely that uncertain conditions associated with the transition to machines under new regulations will continue at least through the first half of FY3/21. The Tokyo Olympics and Paralympics, scheduled to be held in July 2020, should be seen as a particularly negative factor for the industry. Still, as the succession of deadlines for removing machines under previous regulations arrives and the transition to machines under new regulations progresses, we can expect that the appetite for investment aimed at attracting customers, primarily among financially stable major chains, will recover, and the most significant point will be how successful the Company is in getting on a full-scale growth track going into 2H.

## Future strategic direction

### In addition to increasing market share with the AI hall computer "X (Kai)," the Company aims to solidify an earnings structure unaffected by the market environment

In the Company's view, regulatory revisions and other changes in conditions surrounding the pachinko industry will, in the medium to long term, represent a good opportunity for the industry to evolve into one that enjoys even wider public support. The Company's policies are focused particularly on expanding market share with its AI hall computer "X (Kai)" and other next-generation products, as well as on creating new value through its data analytics and planning and development capabilities, which will contribute to industry growth while also leading to improved growth and profitability for the Company itself.

## Future strategic direction

## 1. Information System Segment

The pachinko market's appetite for new investments is likely to remain depressed for at least a while longer. However, equipment demand is gradually stirring due to replacement of game machines in response to the new regulations, and Daikoku Denki intends to develop new products and services that will help it bring in new players, and increase its market share, while maintaining the flexibility needed to respond to changing market conditions. More specifically, the Company has set forth three key measures, as detailed below.

- (1) As before, the Company plans to work at growing its market share and transforming its earnings structure by increasing sales of CR units, information disclosure terminals, and other equipment and an expansion of MG services. Through the provision of MG services in particular, the Company will provide assistance to increase competitiveness and reduce labor costs for pachinko hall operators, and secure its customer base while stabilizing its own sales and earnings.
- (2) The Company plans to make timely introductions of new products and services that have the flexibility needed to meet the changing needs of the market following the new regulations. The Company will also be looking to take advantage of the business opportunities created by the changes in the industry by developing new products and services that will help attract new players (winning back former players as well as attracting new players) including the expansion of various services to provide information to players.
- (3) The Company will reform its business model by deploying the AI hall computer "X (Kai)" that comply with the new regulations in the market and promoting its widespread use, and by continuing to promote investment aimed at helping pachinko hall operators boost efficiency and save labor.

## 2. Control System Segment

In addition to a growing demand for reduced development costs for pachinko and pachislot machines, demand for proposals to cope with environmental changes in market in the future and product planning is becoming increasingly important in the current market environment. In response, Daikoku Denki intends to closely coordinate the efforts of its Control System and Information System segments in order to further differentiate itself from competitors, assure rapid response to changes in the market environment, and raise operating efficiency. Towards this end, the company has laid out three specific measures it intends to implement, as outlined below.

- (1) Contribute to the healthy operations of pachinko halls by emphasizing the entertainment aspect, and focus on revitalizing the game environment through creation of games that comply with new rules.
- (2) Promptly respond to the requests of game machine manufacturers, reduce in-house costs, ensure fast development, and build a stronger quality assurance system, as well as contribute to shortening customers' development period, reduce costs, and improve quality.
- (3) Utilize Information System Segment's DK-SIS data and Fan-SIS data to help implement project proposals that will create new "game value" and help expand business territory.

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## Future strategic direction

Even though the pachinko industry is approaching a major turning point that renders the Company's surrounding profit conditions uncertain from a medium- to long-term perspective, the successful launch of AI hall computer "X (Kai)" aimed at future growth, in addition to its high value-added next-generation products, will give it a major advantage over its competitors. In particular, we see the Company's MG services and value proposal through its unique services and data analysis as putting it in a strong position to meet the changing needs of the industry. Even assuming the pachinko market continues to contract for a while longer, we believe it will be possible for Daikoku Denki to sustain growth with the help of a full-scale rollout of a high value-added lineup of next-generation products that will capture the replacement demand of existing pachinko hall operators. Additionally, polarization is likely to proceed further in the pachinko hall industry with survival mainly by firms with extensive capital resources. These conditions are likely to work favorably for the Company in its efforts to increase market control with the AI hall computer "X (Kai)" and raise market share.

We believe that for the time being, it is necessary to cautiously assess net sales growth, which is readily affected by the external environment, but we should also focus on improvement in profitability through development of products and services that respond to changes in market conditions and expansion of the MG service. From a medium- to long-term perspective, we also anticipate results from the Company's efforts to revitalize the industry as a whole, as it faces a new age with the complete transition to machines under new regulations. We will also keep watch on the Company's efforts to engage directly with pachinko and pachislot fans, amusement fans and new fan segments (including provision of member information via a smartphone app and initiatives that bring people to halls) as well as with pachinko halls and amusement machines manufacturers. Further, as the Company completes a round of major investment in next-generation hall computers and begins collecting on that investment, we need to also monitor its M&A moves, including those outside the industry. Because the Company's expertise in utilizing data can be extended in other areas, we believe M&A will be an important strategy, both for securing a new source of profits and for distributing risk.

## Shareholder returns

### Plans to pay a ¥40 annual dividend in FY3/20 (same as in FY3/19); likely to have room to raise the dividend over the future accompanying profit growth

In FY3/20, the Company plans a dividend of ¥40 per share for the full year (¥10 interim and ¥30 year-end), the same as in FY3/19. Given the Company's policy of supplementing its minimum dividend with dividends dependent on earnings, at FISCO we see the likelihood of future increases in annual dividends as the Company's profits grow.

To make its shares more attractive to investors and to encourage shareholders to keep their holdings over the medium-to-long term, the Company has adopted a system of awarding gifts to shareholders. Shareholders (owning 100 or more shares) as of September 30 each year receive points that can be exchanged with products (more than 600 kinds such as food, beverages, electronic equipment, miscellaneous goods, or donations to social contribution activities) in accordance with the number of shares owned and length of ownership. The Company's IR official explains that this program has been highly praised by individual shareholders.



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